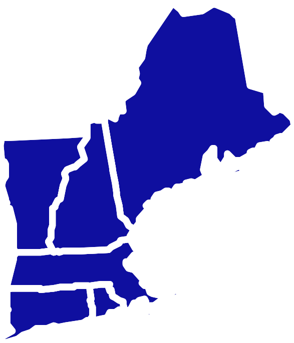
Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — FIRST QUARTER 1997

In Focus This Quarter

FDIC BOSTON REGION



- ***Consumers Declare Bankruptcy in Record Numbers* - Despite generally favorable economic conditions, the number of consumers declaring bankruptcy is on the rise throughout much of the Boston Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress.** *See page 3.*

- ***New Tax Benefits for Owners of Community Banks* - The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.** *See page 6.*

- ***Savings Association Insurance Fund (SAIF) Capitalized* - After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 was passed to address the serious problems of the SAIF.** *See page 10.*

DIVISION OF INSURANCE

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Dear Reader,

The prototype edition of the *Regional Outlook* for the Boston Region is attached. The *Regional Outlook* is produced by the Division of Insurance (DOI) and is designed to discuss events and trends affecting insured depository institutions in your region. This publication will be produced and distributed quarterly in our effort to share information and work with the Divisions of Supervision (DOS) and Compliance and Consumer Affairs (DCA) to identify emerging risks to insured depository institutions.

The publication contains two sections. The first section, *In Focus This Quarter*, contains several articles which are designed to address significant issues affecting insured depository institutions. The articles are not intended to represent an exhaustive coverage of the subject matter or to be examination guidance. The second section, *Regular Features*, will focus on the Regional Economy, Financial and Commodity Markets, and Banking. This section is not intended to be a substitute for your local or national newspaper but is intended to address some emerging trends and relate them to insured depository institutions.

This publication is regional in focus with individual states and metropolitan areas highlighted where possible. We recognize the importance of local economic information to examiners and intend to address that particular need more thoroughly in another product. DOI will provide periodic economic analyses at the Field Office level in the future.

This publication may be distributed on a wider basis in the future, but it was designed largely with an examiner audience in mind. DOI is very appreciative of the time and constructive feedback members of DOS's and DCA's Chicago staffs provided in the design and testing of the *Regional Outlook*. Many of the suggestions received from those individuals were incorporated into this publication. Your comments on the publication's format and contents, including suggestions for future articles, are welcomed. We also would appreciate your thoughts about the desirability of providing this publication by way of our intra-net homepage, or some other electronic format.

Sincerely,

Arthur J. Murton
Director

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Consumers Declare Bankruptcy in Record Numbers

Trend Raises Concerns about Consumer Credit

- **Despite favorable economic conditions, personal bankruptcy rates are rising throughout the Boston Region.**

- **Bankruptcy rates in the Region are generally lower than the national average.**

- **Credit card charge-offs are approaching recession levels.**

Despite generally favorable economic conditions, the number of consumers declaring bankruptcy is on the rise throughout much of the Boston Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress. Both the Senate and House Banking Committees have held hearings on the condition of consumer credit, particularly credit card lending. Much of the concern regarding these trends is due to the fact that bankruptcy filings and charge-offs are rising despite low unemployment and rising income levels.

How Do the New England States Compare?

New England's bankruptcy trends are similar to the nation's but somewhat more favorable (see Chart 1). Both New England and national bankruptcies reached their prior peak in 1992, declined slightly for two years, and are now climbing again. Bankruptcy filings accelerated rapidly during 1996 and have reached new record levels. Individually, the six states in the Region have followed this same basic pattern.

National rankings show the following:

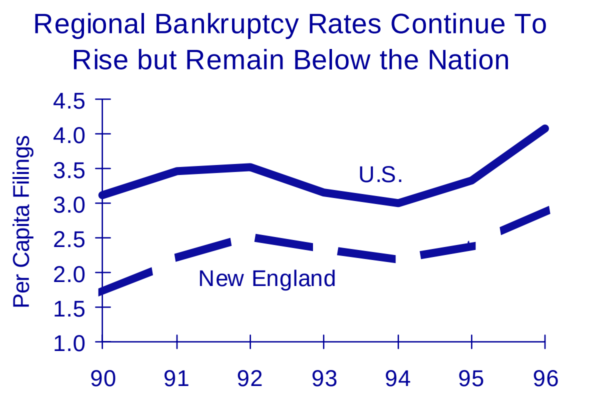
- Rhode Island has the highest level of bankruptcies per capita of any state in the Boston Region, ranking twentieth nationally with roughly four bankruptcies per 1,000 residents.
- Connecticut and New Hampshire rank twenty-ninth and thirty-third, respectively, while Massachusetts ranks forty-first. All three states rank significantly below the national average.
- The more rural states of Maine and Vermont rank forty-eighth and forty-ninth, both with just over two bankruptcies per 1,000 residents.

Chart 2 shows the rising trend in consumer loan losses in the Boston Region as well as the close relationship between these losses and personal bankruptcy filings.

Why Are Consumer Credit Losses Rising in an Expanding Economy?

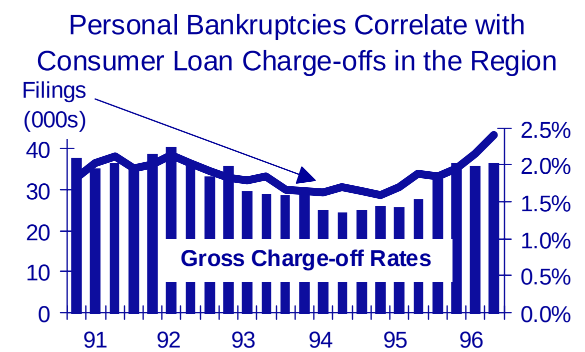
The emergence of consumer credit problems during an expanding economy is not unprecedented. During the last economic expansion, consumer delinquency and charge-off rates also rose. Consumer debt tends to rise when employment rises because households are more

CHART 1



Source: Administrative Office of the United States Courts

CHART 2



Sources: Administrative Office of the United States Courts and Bank and Thrift Call Reports (RIS). Based on a design by the FDIC's Division of Research and Statistics.

PROTOTYPE

willing to incur debt and banks are more willing to lend. Chart 3 shows that past cycles of rising growth in consumer credit have been followed by rising delinquency rates, even during periods of expansion.

As the expansion closes out its sixth year, American consumers are holding historically high levels of consumer debt -- the ratio of total consumer debt service payments, including mortgage, to disposable personal income is approaching record highs and is currently at 17 percent. High debt levels appear to be the result of several years of economic expansion along with credit card companies' intensive efforts to generate and feed consumers' appetite for credit. Consumers and their lenders are now experiencing the after-effects of this credit expansion.

Why Are Bankruptcy Rates Rising?

Nonbusiness bankruptcy filings for 1996 will exceed one million for the first time in U.S. history. This level is 11 percent higher than the peak in the last recession and a 14 percent increase over 1995 filings. A variety of theories have been advanced to explain this trend. These theories include the following:

- Consumers have overextended themselves.
- Recent changes in bankruptcy laws make it easier to shield assets from creditors.
- Changes in legal practices promote bankruptcy.
- The social and financial repercussions associated with bankruptcy have diminished.

In fact, the trend is likely the result of several factors, many of which are interrelated.

A recent study by ***SMR Research Corporation*** attributes differences in filing rates more to state regulations than to economic conditions. The study found that bankruptcy is driven by the number of and exposure to catastrophic events. The report identifies several important factors such as:

- inadequate health insurance;
- inadequate auto insurance;
- a large percentage of self-employed workers;
- garnishment of wages;
- high debt-to-income ratios; and,
- high divorce rates.

All of these conditions increase consumers' exposure to catastrophic events, such as job loss, that are typically associated with personal bankruptcy.

Of interest to lenders is that some traditional early warning signs of trouble -- such as erratic missed payments or paying off a smaller share of outstanding balances -- are not evident this time. *Some banks are finding that obligations due to them are being wiped out in bankruptcy court on accounts that showed no prior problems.*

Implications for Insured Institutions

These trends have raised concerns about the outlook for credit card lenders. As shown in Chart 4, credit card charge-offs are approaching levels not seen since the aftermath of the 1990-1991 recession. During that recession, charge-off rates increased sharply. The question arises whether there would be a similar sharp increase in credit card losses during a future recession, driving credit card loss rates to levels well above their previous peak.

This concern is heightened by a number of factors. Consumer debt burdens are at historic highs. Profit

CHART 3

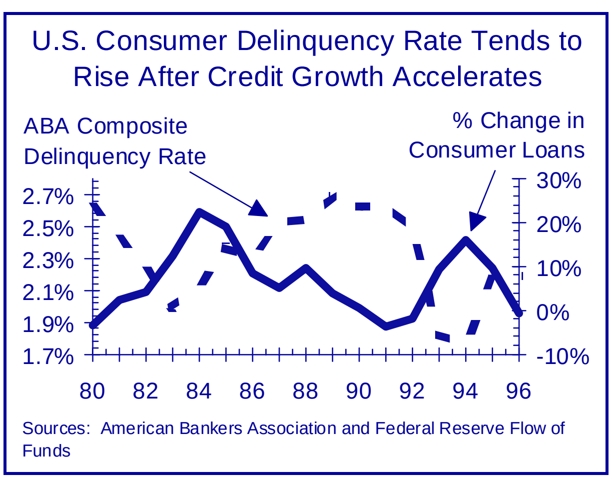
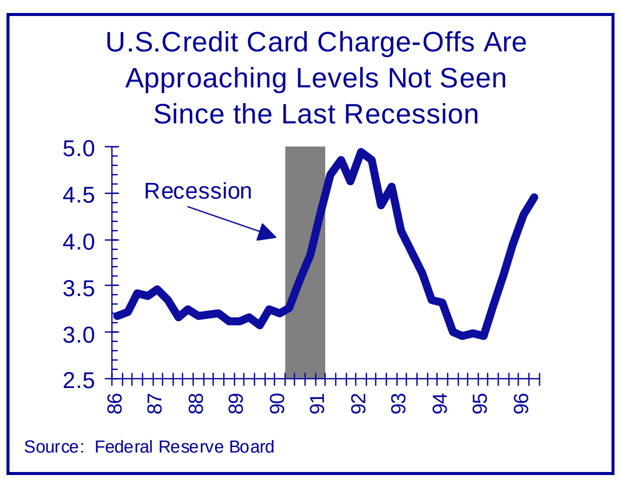


CHART 4



margins for the nation's specialty credit card lenders (institutions whose total loans exceed 50 percent of managed assets and whose credit card loans exceed 50 percent of total loans) have rapidly narrowed from a 4.25 percent quarterly return on assets (ROA) in the third quarter of 1994 to a 2.02 percent quarterly ROA in the third quarter of this year. Competitive pressures on pricing and underwriting remain intense, as some companies continue aggressive card solicitations, and there are few signs of any slackening of price competition. A sharp rate cut for AT&T credit cards, one of the largest credit card lenders, is a recent salvo in this price competition. *Lenders also place great reliance on credit scoring models that have not yet been tested in a recession* and, according to a recent Federal Reserve survey, appear overly optimistic in almost two-thirds of the banks surveyed.

Other factors mitigate these concerns to some extent. Pricing of credit card loans has traditionally built in a margin of comfort for high and volatile losses. Loan portfolios are diversified with many small loans to individuals. There are preliminary indications that lenders and borrowers are retrenching to some extent. Consumer credit growth slowed from over 14 percent in both 1994 and 1995 to an annualized rate of 8 percent (seasonally adjusted) for the first ten months of 1996. In the Federal Reserve survey just mentioned, two-thirds of banks reported raising the score an applicant must achieve to qualify for credit, and one-third reduced credit limits for existing customers.

New England banks, on the whole, show lower delinquency and charge-off rates than the national averages. There are only two true credit card banks in the Region, both of which have loss rates below the national average, as well as strong earnings and capital.

Generalizations about the outlook for credit card lending are difficult. Trends that describe the industry on average may not hold true for particular institutions. Performance is likely to vary substantially, with results depending on the risk management practices and underwriting standards of each institution. Given the trends outlined above, credit card lending practices appear worthy of continued close attention by bankers and regulatory agencies.

Diane Ellis, Senior Financial Analyst
Laura Filkins, Division of Supervision

New Tax Benefits for Owners of Community Banks

Subchapter "S" Benefits Now Available

- **Potential benefits are substantial. A layer of tax expense has been eliminated.**
- **Eligibility is restricted and requires care to maintain.**
- **While no application to the banking agencies is required, the new tax structure has supervisory implications.**
- **The new tax structure has some potential drawbacks.**

Introduction

The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.

Eligibility Is Restricted

The new law allows, for the first time, financial institutions including banks, thrifts and holding companies to elect subchapter "S" status if they meet several criteria. *The most important of these requirements are that the company not use the reserve method of accounting for bad debts for tax purposes and that it have 75 or fewer eligible shareholders.* All shareholders must consent to the subchapter "S" election and the IRS must consent to any change in the tax accounting for bad debts. To be able to receive the benefits for tax year 1997, institutions need to meet the requirements by year-end 1996.

Reserve accounting for bad debts for tax purposes is an issue affecting only smaller institutions. Currently, reserve accounting is allowed only for those thrifts and banks under $500 million in assets that are not part of a group with more than $500 million in assets. To elect the new tax status, the subchapter "S" company will need to make the accounting change to the specific charge-off method for tax purposes. Presumably, the IRS will not object to any such change, which can delay deductions and increase taxable income, and will allow the change to be effective as of the beginning of the tax year.

In relation to shareholder eligibility, ownership of subchapter "S" corporations is limited to individuals, estates and a few types of trusts. At present, certain shareholders, such as corporations, Employee Stock Ownership Plans (ESOPs) and other stock bonus plans, may not hold shares in subchapter "S" corporations. Once the subchapter "S" election is taken, the corporation and its shareholders must take care to continue to meet all eligibility requirements or risk losing the tax benefits.

Benefits to Shareholders

The tax benefits of the "S" corporation are similar to those of a partnership. The earnings of the corporation generally are not taxed at the corporate level but pass directly to shareholders' personal income. *As such, cash distributions to shareholders are not subject to an additional layer of taxation, which results in a reduction in overall taxes.* Shareholders remain liable for personal taxes on their proportionate share of the corporation's taxable income. Distributions formerly paid directly to the IRS by the institution generally would be made to the shareholders, providing them with the funds to pay income taxes on their share of the corporate income. An interagency letter, FIL-91-96 dated October 29, 1996, notes that these distributions will be treated as dividends by the regulatory agencies.

Industry observers have suggested that over 1,000 banks nationwide will make the subchapter "S" election.

Table 1 illustrates the tax advantages of an "S" corporation. In this example, assume that a bank under the traditional corporate tax structure ("C" corporation) has pre-tax earnings of $1,000, that tax rates are 40 percent at both the corporate and the shareholder level, and that the dividend payout rate is 50 percent of net income. These conditions for the bank are shown in column A. Under this scenario, the bank retains earnings of $300, while the net return to shareholders is $180.

Column B illustrates how under the "S" corporation structure an additional $120 of earnings is retained at the corporate level ($420 versus $300), while the net return to shareholders remains the same as under the "C" corporation structure ($180).

If retained earnings are held at the same level under the traditional corporate tax structure, as illustrated in Column C, return to shareholders increases to $300, a 67 percent increase over the return under the "C" corporation structure. For illustration purposes, tax rates were held constant at 40 percent but will vary widely depending on such things as geographic location and marginal tax rates. As this example illustrates, the "S" corporation structure may be most advantageous for institutions in a low growth mode, with little need to retain earnings at the corporate level. In these particular cases, the return to shareholders can be enhanced significantly.

In addition to the elimination of a layer of taxation, there is an additional tax benefit to the "S" corporation structure, related to the taxation of capital gains. Banks generally retain a large portion of income as capital to support anticipated growth. Retained earnings increase the value of a bank and therefore increase the value of its stock. Shareholders of a bank operating under traditional corporate tax rules do not receive an increase in the tax basis of their stock based upon this increase in value. However, "S" corporation shareholders increase the tax basis of their investment by the amount of income retained by the bank. This higher tax basis means that shareholders would have a smaller capital gain in the event of a stock sale. A smaller capital gain translates into a smaller capital gains tax for additional tax savings.

Adding value and flexibility to the "S" corporation structure is the ability to wholly own other "S" corporations. These rules allow holding companies and their bank or savings association subsidiaries to be "S" corporations.

Other Tax Liabilities

For bank or thrift companies that elect to convert to "S" corporation status, there are potentially some other corporate tax liabilities for unrealized gains accumulated through the date of conversion. As an example, should the fair market value of all company assets exceed the adjusted tax bases of these assets, there may be some corporate tax liability if any assets are later sold. Assets held on conversion date and sold within the next ten years require a calculation for "Built-in Gains Tax" (BIG tax) to determine any tax at the corporate level.

Other Drawbacks

To receive the benefits of the subchapter "S" election, the institution will need to meet all the eligibility requirements for every day of the tax year. Furthermore, the IRS has not yet resolved all the tax issues related to the subchapter "S" election on the part of financial institutions. Specific guidelines from the IRS are expected by year-end 1996 which may affect an institution's decision to elect subchapter "S" status.

Table 1

Tax Advantages of an "S" Corporation

	A "C" Corp	B "S" Corp	C "S" Corp
Corporate earnings, pre-tax	$1,000	$1,000	$1,000
Corporate taxes	400	0	0
Net income after tax	600	1,000	1,000
Dividend/Distribution	300	580	700
Retained earnings - Corporation	300	420	300
Shareholder income	300	580	700
Shareholder taxes*	120	400	400
Net Income to Shareholder	$180	$180	$300

*Shareholder taxes for "S" Corp are based on $1,000 pre-tax corporate earnings at 40%.

Prototype

The states of **Connecticut,** Michigan, **New Hampshire**, New Jersey, and Tennessee, as well as the District of Columbia, do not recognize the federal subchapter "S" election. Therefore, these jurisdictions do not allow the pass-through benefits of the "S" corporation for the applicable state or district taxes.

Subchapter "S" institutions remain under the same capital adequacy standards and dividend restrictions as other institutions. However, there are times when it may be difficult to maintain the subchapter "S" status. An example would arise when an institution needs to raise capital to meet Prompt Corrective Action (PCA) guidelines. *To meet the IRS requirements for subchapter "S" election while raising the necessary capital, current shareholders may have to be the primary source of new capital.* The ability to raise additional capital by attracting new eligible shareholders may be difficult because the total number of eligible shareholders must remain 75 or fewer to preserve the "S" status. Furthermore, no new classes of stock may be issued. Violation of any of these criteria would result in the loss of the subchapter "S" status and reversion to regular corporate tax rules.

Distributions to shareholders are covered by similar restrictions for subchapter "S" corporations as for regular corporations. However, one possible new twist is that, in some cases, the tax liability payment for shareholders may be due before distributions are funded from the institution. However, this is considered similar to pressures brought by shareholders in other corporations when they require dividend payments to fund debt payments on stock loans.

Supervisory Implications

While an application to bank regulators is not required for this tax election, there may be a rise in various "phantom bank mergers" or change-in-control applications as companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

Shareholders may enter agreements that place limits on their ability to sell their stock. In addition, the mechanics of a conversion will require some special expertise for the bank in tax law and accounting. The change from the reserve method to the specific charge-off method for bad debts or the existence of net operating losses may present unique circumstances for each institution.

Bank portfolios also may undergo changes prompted by shareholders' requests. An example might be increased purchases of tax-free securities to meet the desires of shareholders for more tax-free interest. Another may arise from a tendency to remove accumulated earnings to pay personal taxes as the corporation generates earnings. This could place a strain on capital in situations where growth is strong or delinquent assets are rising.

There may be a rise in various "phantom bank mergers" or change in control applications as the companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

Election of "S" corporation tax status also has implications for financially troubled institutions and distributions to "S" corporation shareholders. The FDIC currently considers such distributions to be dividends; therefore, the FDIC has the authority to restrict or prohibit distributions in a problem institution. It is conceivable that taxes would have to be paid by individual shareholders regardless of whether an actual distribution or dividend had been paid. This is obviously not advantageous for shareholders.

Operating losses of an "S" corporation also can result in a more rapid deterioration of a bank's financial condition as losses flow through to the bottom line, dollar for dollar. This is because the "hidden capital" available to most "C" corporations through tax loss carrybacks is not available to the "S" corporation. In this situation, shareholders will continue to receive a benefit in the form of reduced personal income taxes to the extent that the bank's operating losses shelter other personal income.

While figures on the number of eligible institutions are not available, the numbers of small banks in the Region may provide some insight. There are approximately 90 banks in the Boston Region with less than $250 million in total assets (excluding mutual savings banks), and some of these banks may meet the current eligibility requirements. It is likely that this type of structure will be most beneficial for smaller community banks which are closely held, probably by a family or related groups. This type of tax conversion is likely to be more common in other regions of the country, where small, rural banks are frequently owned and operated by family interests. Industry observers have suggested that over 1,000 banks nationwide will make the subchapter "S" election.

There may be an increase in de novo applications and leveraged buyouts as investors see the tax advantages to owning a bank. Investors in new "S" corporation banks can get an immediate return on their investment through tax losses. Ordinarily, investors would have to wait years until a new bank could achieve a level of profitability sufficient to support dividend payments. Changes in tax status also may slow down the pace of mergers and acquisitions. Because an institution's shareholders profit from the "S" tax structure, an acquirer might have to pay much more to entice "S" corporation shareholders to sell than would normally be true for "C" corporation institutions.

New Value for the Community Bank Charter

Overall, this newly legislated tax break for closely-held financial institutions may invigorate the value of the community bank or thrift. However, it also adds a new "wrinkle" in the complexity of the examiner's job. While consolidation trends can be expected to continue at larger companies, the new tax benefits available for closely-held institutions add a new incentive for the survival of community banks and thrifts.

Ronald L. Spieker, Chief,
Depository Institutions Analysis Section,
*Daniel Frye, Senior Regional Analyst **

** Extensive review and comments were provided by Robert F. Storch, Chief, Accounting Section of the Division of Supervision.*

For More Information

Subchapter S Election for Federal Income Taxes. FIL-91-96.

Savings Association Insurance Fund (SAIF) Capitalized

FDIC Lowers Assessment Rates

- **SAIF was capitalized through a $4.5 billion special assessment. Banks and thrifts in the Boston Region paid $70 million of this total.**

- **Bank Insurance Fund (BIF) members will bear part of the cost of the Financing Corporation (FICO) bonds beginning in 1997.**

- **The special assessment negatively affects 1996 operating performance, but earnings prospects are greatly enhanced by a proposal to lower future SAIF assessment rates.**

Why Was Action Needed?

After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 (Act) was passed to address the serious problems of the SAIF.

The difficulties facing the SAIF were substantial and demanded a solution. They primarily fell into the following areas:

- SAIF was undercapitalized and there was concern that one large, or several sizable, thrift failures could quickly deplete the fund balance. Its balance was $3.9 billion, or 0.55 percent of insured deposits, on June 30, 1996, well below the target reserve ratio of 1.25 percent of insured deposits.

- Over 45 percent of SAIF assessments were being diverted from the SAIF to pay off FICO obligations arising from the thrift failures of the 1980s.

- The SAIF assessment base continued to shrink, with a 22 percent reduction noted from year-end 1989 to June of 1996.

- Disparity between SAIF and BIF premiums created strong economic incentives for institutions to transfer SAIF-assessable deposits to affiliated institutions insured by the BIF, contributing to the shrinkage in the SAIF assessment base.

Nearly 80 percent of the Boston Region's institutions paying the special assessment posted a quarterly net operating loss for the third quarter of 1996 ...

Table 1

Boston Region Institutions Affected by SAIF Special Assessment

# of Institutions Affected and Total Assessment by Type	BIF Insured Savings Banks		SAIF Insured Savings Banks		Commercial Banks		Total	
	#	$000	#	$000	#	$000	#	$000
Connecticut	4	1,039	12	17,354	1	1,163	17	19,556
Massachusetts	5	683	23	18,685	6	8,429	34	27,797
Maine	3	1,814	10	2,508	0	0	13	4,322
New Hampshire	2	1,023	6	6,390	3	731	11	8,144
Rhode Island	1	4,535	2	422	1	474	4	5,431
Vermont	0	0	3	4,640	0	0	3	4,640
Total	15	9,094	56	49,999	11	10,797	82	69,890

Source: Derived from early estimates from the FDIC's Division of Finance.

What Significant Actions Were Taken?

Special Assessment: In order to address the immediate problems, *the Act required the FDIC Board of Directors to impose a special assessment of approximately 65.7 basis points on SAIF-member institutions.* The special assessment was designed to increase the fund's level to 1.25 percent of insured deposits effective October 1, 1996. In determining the amount, the Board:

- Exempted weak and other specifically defined institutions from paying the special assessment.

- Decreased by 20 percent the amount of SAIF-assessable deposits against which the special assessment will be applied for certain Oakar and other institutions. (An Oakar institution is a member of one insurance fund that has acquired deposits insured by the other fund. The acquired deposits retain coverage under the seller's fund.)

There were no exempted institutions in the Boston Region. Eighty-two institutions in the Boston Region collectively paid about $70 million to the SAIF in November. As Table 1 (previous page) indicates, the special assessment affects more than just thrifts. This is due to the substantial number of banks that have acquired SAIF deposits through acquisitions or branch purchases over the last few years.

Table 2

Summary of 1997 Assessment Rates *

1997 Adjusted BIF & SAIF Schedule			
Capital Group	Supervisory Subgroup A	B	C
1	0	3	17
2	3	10	24
3	10	24	27
Exempt Institution SAIF Schedule			
1	23	26	29
2	26	29	30
3	29	30	31

FICO Annual Rates	
BIF Institutions	SAIF Institutions
1.30	6.48

* Cents per $100 of domestic deposits

Source: FDIC's Division of Insurance

FICO Costs: The recently enacted legislation also addressed another legacy of the problems thrifts experienced in the 1980s -- FICO bonds issued in 1987 to help shore up the former Federal Savings and Loan Insurance Corporation (FSLIC). The cost of financing this debt, about $800 million per year, was a major reason the SAIF had not improved as quickly as the BIF.

The Act authorized FICO to impose periodic assessments on BIF members in addition to members of SAIF that were already being assessed. The FICO charge on BIF-assessable deposits must be one-fifth the charge on SAIF assessable deposits. As a result, *the FICO charge on SAIF-assessable deposits for the first semi-annual assessment period of 1997 will be 6.48 basis points (annualized), and the charge on BIF-assessable deposits will be 1.30 basis points (*see Table 2). As necessary, FICO rates will be adjusted on a quarterly basis to reflect changes in the assessable-deposit bases for the BIF and the SAIF. Beginning on January 1, 2000, or, when the insurance funds merge, whichever occurs earlier, BIF and SAIF members will share the FICO assessment on a pro rata basis. (FICO assessments will be paid in addition to the deposit insurance assessments. See discussion below.)

Final Rule to Lower SAIF Assessment Rates: With the SAIF now capitalized by the special assessment, the FDIC Board of Directors lowered the rates on ongoing assessments paid to the SAIF. The Board also widened the spread between the lowest and highest rates to improve the effectiveness of the FDIC's risk-based premium system.

The final rule establishes an adjusted SAIF rate schedule of 0 to 27 basis points effective for all non-exempt institutions beginning January 1, 1997. (Since only SAIF-member savings associations must, by law, pay for FICO assessments until the end of 1996, a special interim rate was established for SAIF-member savings associations for the last quarter of 1996.)

As is noted in Table 2, institutions exempted from paying the special assessment will not benefit initially from the lower SAIF assessment rates. They will pay according to the 23- to 31-basis point schedule through year-end 1999, unless they choose to make a pro rata payment of the special assessment in the interim.

Implications for Insured Institutions

Institutions that are required to pay the SAIF special assessment should have accrued a liability and an offsetting noninterest expense as of September 30, 1996. As a result, many such institutions will reflect much lower operating earnings this year. In fact, nearly 80 percent of the Boston Region's institutions paying the special assessment posted a quarterly net operating loss for the third quarter of 1996 primarily due to the special assessment.

Concerns over the short-term financial impact described above are moderated by much brighter future prospects. First, the special assessment is a one-time charge and should not affect future earnings streams of nonexempt institutions. Second, the proposed lower SAIF assessment rates should actually help to boost net income in 1997. Finally, some observers have noted that the resolution of the SAIF's deficiencies should remove uncertainties that may have depressed stock prices of SAIF-member institutions. Over the longer-term, the capitalization of the SAIF and the change in assessment rates also pave the way for a dialogue about a possible merger of the two deposit insurance funds.

John D. Weier, Chicago Senior Regional Analyst

For More Information

- SAIF Assessments. FIL-88-96
- Accounting for the SAIF Special Assessment and FICO Assessments. FIL-90-96
- Federal Register 61, No. 201, pp. 53834-53841: Assessments.
- Federal Register 61, No. 201, pp. 53867-53876: Proposed Rules - Assessments.
- Press Release 79-1996 and 63-1996.
- Chairman Helfer's Speeches: July 19, 1996, and October 28, 1996.

Boston Region: Recovery Continues Slowly But Steadily

- **New England has been in recovery for four years, but some areas dominated by depressed industries (fishing, defense, insurance) are lagging.**
- **Weak population inflows and a generally high cost of doing business are likely to hamper further economic growth, increasing the Region's susceptibility to any U.S. slowdown.**
- **The growing importance of financial services to real estate and employment may change the nature of economic risks in the Region. Consolidation and deregulation in health care and utilities also may pose risks in 1997 and beyond.**
- **Commercial real estate markets are tight around the Boston area. Growth in employment from technology and financial services companies has absorbed much of the existing space, although speculative building**

Who Will Fill New England's Jobs?

The ongoing economic recovery has slowly spread from the northern-most states (where jobs lost to the recession have already been restored) to the South. Connecticut, because of its prior reliance on defense manufacturing and a consolidating insurance industry, continues to lag the rest of the Region's recovery. The pace of recovery in New England has been anemic, at best. An example of this can be seen in the Region's slow pace of job creation in recent years (see Chart 1). In 1996, for instance, the Region saw job growth of only 1.2 percent — little more than one-half the national pace of 2.2 percent.

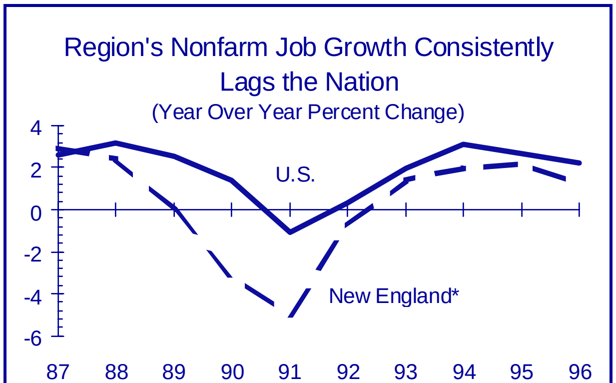
Population outflows, and thus reductions in the labor force, have helped the Region to obtain unemployment rates generally below those in the rest of the nation. However, *low statewide unemployment rates disguise some persistent pockets of higher unemployment across the Region*, particularly in rural areas or in areas dominated by one or two industries currently in decline, such as defense, insurance, and fishing.

Future economic growth in New England will hinge on drawing new labor supply to the Region and on reemploying qualified but "discouraged" workers who are still in the Region but are not counted in the official statistics. *Firms are currently having trouble filling high-end jobs in technology fields* due to a limited number of qualified U.S. applicants. Further, limits on skilled immigrant labor to fill these posts are a concern among many technology companies in New England. Retailers and other employers that are seeking to fill low-wage jobs also are finding it difficult to hire enough employees.

National developments, such as the ongoing *consolidation in financial services and health care, as well as progress toward electric utility deregulation, may pose some risk to the Region's economy in the coming year*. Furthermore, the Region's generally high cost of doing business (labor and energy) will likely continue to limit development going forward -- particularly in manufacturing. Unfortunately, *five of the six New England states have the dubious distinction of being in the top-ten most costly states in the nation.* According to rankings by Regional Financial Associates, Connecticut ranks second (behind Hawaii), Massachusetts takes fourth, Vermont eighth, Rhode Island ninth, and Maine tenth -- New Hampshire is close behind in twelfth place.

Implications: The *anemic economic expansion may add to consolidation pressures, as banks try to pre-*

CHART 1



Note: Regional data for 1996 are annualized.
Source: Bureau of Labor Statistics

serve revenue and earnings growth. Limits on labor supply also could result in rising wages, further hampering the Region's business climate. The negative effects of slow growth in New England may be offset somewhat by the diversity of industries in the Region, such as financial services and technology companies that rely on broader U.S. and international markets for much of their revenue growth. Also, as can be seen in Chart 2, the Region's recovery has resulted in fewer business failures, thus reducing credit risks for banks with commercial loan exposures.

Region Continues Industry Diversification

Services and Trade Driving Growth: Economic activity in the six-state New England area is centered in Massachusetts (47 percent of the Region's personal income) and Connecticut (29 percent). Both states' economies are fairly well diversified across the services, trade, and manufacturing sectors as measured by shares of labor income. Services and trade have accounted for most of recent job gains. In Massachusetts and Connecticut, industry concentrations exist in financial services (insurance and mutual funds), health care, transportation equipment (mostly defense-related), electronics/computers, education, business consulting, and allied services.

While manufacturing employment generally declined during the first ten months of 1996, business services and health care produced some of the major job gains in Massachusetts and Connecticut.
The northern part of the Region's economy (Vermont, New Hampshire, and Maine) is more intensely driven by tourism and natural resource industries (forest products and fisheries) than are the southern-most states.

Retail Sector Rebounding: Strong labor demand and earnings, both for entry-level and skilled/professional positions, should help retail sales rebound from a weak 1995. A strong stock market should support wealth-effect spending for upper-end and luxury retailers, while strong home sales should benefit sales of furniture, appliances, and other durable goods across the Region in the fourth quarter.

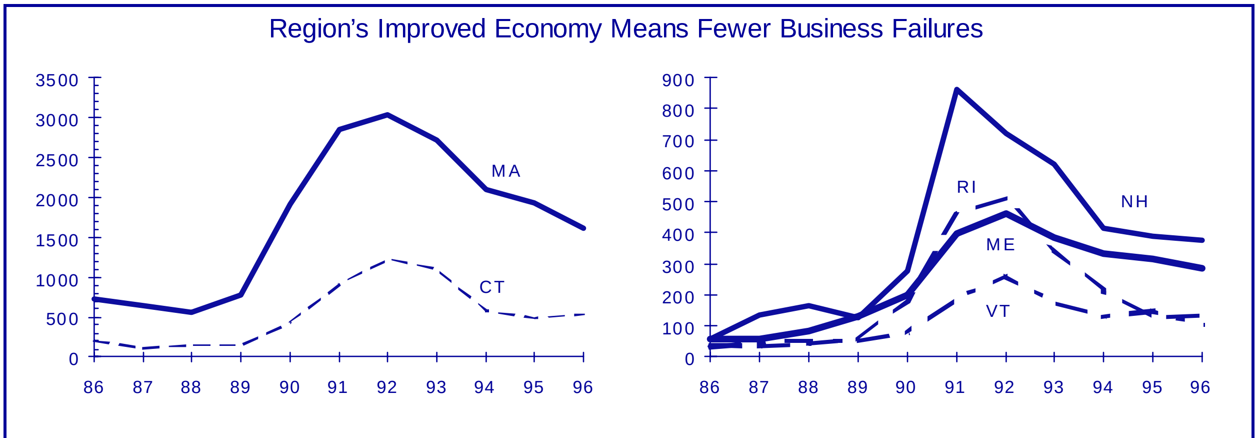
Year-to-date through September 1996, *retail sales in Massachusetts were up 7.2 percent over 1995.* The comparable figure for last year was a meager 2.8 percent, while the year-over-year gain in 1994 was 8.4 percent (the highest since 1988).

Implications: The retail climate in the Region, mirroring national trends, has seen large mass-market retailers acquiring dominance over traditional retailers. This has affected local real estate markets, as these new formats require larger, built-to-suit space -- usually in suburban areas. Fortunately, many smaller retail buildings are turning to specialty/non-retail tenants, keeping overall vacancy rates low. *This reuse of space has mitigated risks to financial institutions with retail real estate exposure.*

Real Estate Markets Firming

Existing Home Sales Fully Revived

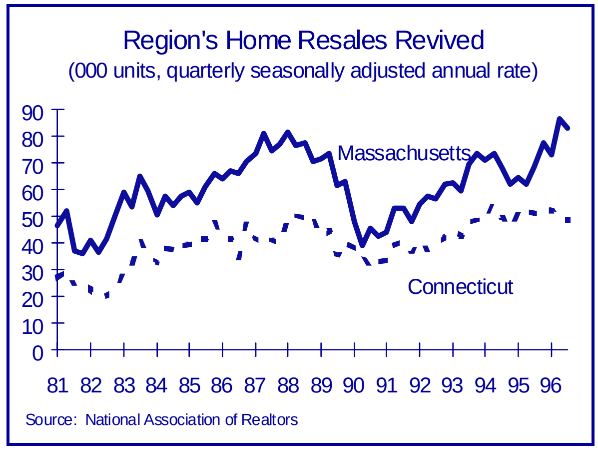
CHART 2



Note: Data for 1996 are annualized.
Source: Dun & Bradstreet

Despite a dearth of population growth, existing home sales have been strong in many parts of the Region. This has been due to the limited availability of rental housing and a recovery in home prices; frustrated owners have finally seen prices surpass their original purchase price, encouraging them to list their homes. Quarterly sales figures through September 1996 show that sales rates have reached (and surpassed) their mid-1980s highs in Massachusetts (see Chart 3). New Hampshire sales also have recently surged to new all-time highs. Connecticut's market has recovered from its 1990 slump, but sales have remained relatively flat for the last three years.

CHART 3



During the second quarter of 1996, median *existing home prices surpassed their late 1980s peak,* rising 9 percent in the greater Boston area from a year earlier versus a 7 percent increase nationally. Inflation-adjusted prices, however, remain about 20 percent below their last high. In Connecticut, prices over the year were up 5 percent in Hartford (but off 15 percent from their 1988 high).

Implications: Expectations for limited population growth in the Region probably will mean home sales activity will stabilize or fall somewhat from current peaks. As banks' mortgage origination businesses come under pressure from lower volume growth, some focus may shift to home equity lending. New mortgage growth may depend to some extent on the continuation of favorable interest rates. *Turnover in existing homes should be supported by owners seeking to trade up (or down) into newer homes and by renters driven to ownership by the Region's rising rental rates and dearth of quality rental housing.*

Commercial Real Estate Improved

TABLE 1

COMMERCIAL VACANCY RATES IMPROVED

	3Q96		LAST PEAK	
	INDUSTRIAL	OFFICE	INDUSTRIAL	OFFICE
BOSTON	7.9	8.2	10.1	18.4
HART-FORD	8.6	22.8	14.3	25.2
STAM-FORD	6.3	15.0	12.7	32.8

NOTE: DATA COVER THE METROPOLITAN AREA AND ARE AVERAGE FOR THE PERIOD.
SOURCE: CB COMMERCIAL

Apartments: As evident in Table 1, the Region's commercial real estate markets have generally improved since the depths of the last recession. However, pockets of excess office space (and high vacancy rates) persist in such cities as Hartford, CT. In Massachusetts, the high costs of land and property management services, coupled with little lender interest, have limited builders in many areas to only those projects with government subsidies -- *the number of permits issued for multi-family dwellings has stagnated in 1996.* As a testament to the tight market, the average acquisition cost for class "A" apartments in the Boston area rose 8 percent between the third quarter of 1996 and a year earlier. At the end of 1995, Connecticut had the most abundant supply of unused rental housing -- a 15 percent vacancy rate versus 7.6 percent for the U.S. -- although rates around Hartford were a much lower 9 percent.

Office: Despite a brief rise in the first quarter of 1996, *office vacancy rates have held below 10 percent in the greater Boston area* since the middle of 1995 -- after rising above 18 percent in 1990 and 1991. By contrast, the national average as of mid-1996 was 13 percent. Office vacancy rates for the greater Boston area averaged 8.2 percent in the third quarter of 1996.

The Boston metropolitan area's two largest markets are downtown (45 percent of inventory) and just west of the city, along Route 128 (29 percent). Cambridge and the combined markets along interstate 495 and around Framingham ("metrowest") each account for another 10 percent of office space.

Financial services (mutual fund companies), law firms, and consulting companies were responsible for much of the incremental demand for Boston's office space in 1996. Many research and development-driven technology companies seek to position their operations near universities in Boston/Cambridge, pushing up demand for office and light industrial space close to downtown. *Most new office construction likely will be limited to the greater Boston area in 1997,* with approximately 7 million square feet in the early planning stages as of last August. If put in place, this would represent a 7 percent addition to existing inventory.

In Connecticut, *Hartford continues to be plagued by excess office space.* Vacancy rates there (both in the downtown and suburban markets) are still above 20 percent. Construction in Stamford, CT, is beginning to recover from a five-year slump caused by corporate downsizing and an overbuilt market. Although the Region continues to maintain its attractiveness as an alternative to nearby midtown Manhattan, vacancy rates remain fairly high,but the trend is one of improvement. The proportion of unused office space in Stamford dropped from 17 to 18 percent in 1995 to 15 percent in third quarter 1996.

Industrial: Industrial vacancy rates in the greater Boston area rose through the third quarter of 1996 to 7.9 percent, after falling to 5 percent in late 1995. Still, the current rate remains below the modest peak of 10 percent in late 1991. Demand remains brisk (and vacancy rates low) south of Boston for warehouse space, while north of the city, growing technology companies are fueling demand for industrial facilities. In Connecticut, industrial vacancy rates hit 8.6 percent in Hartford, while rates in Stamford continued to decline in 1996, reaching a level of 6.3 percent in the third quarter.

Implications: Despite strong demand for space around Boston, development has thus far been limited mostly to built-to-suit or significantly pre-leased projects. *A reticence to fund speculative projects may prevent local markets from becoming overbuilt in the near term.* Much of greater Boston's office space is occupied by a few industries, such as financial services and technology firms. *If these key tenant industries were to decline, there would be a significant negative impact on occupancy rates.*

Norman Williams, Regional Economist

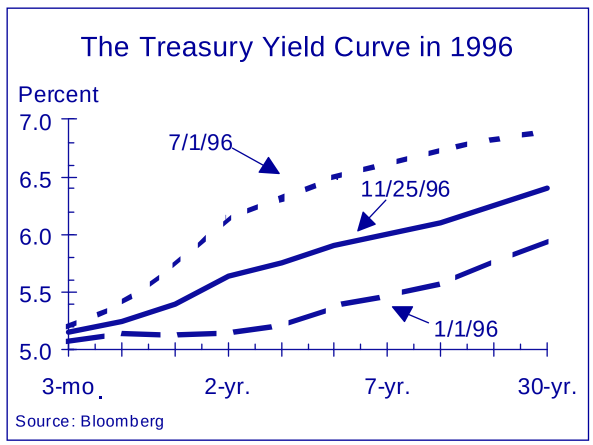
Financial and Commodity Markets

- **The Treasury yield curve remains steeper than at the beginning of 1996, but it has flattened since July.**
- **The Boston Region's bank stock index has outperformed the S&P 500 so far this year, but it has underperformed the S&P Composite Bank Index.**
- **Evidence suggests that changes in the slope of the short-end of the yield curve may be a good predictor of bank stock performance relative to the broader market.**
- **New yield curve spread futures and options offer an alternative to managing exposures to twists in the yield curve.**

Changes in Interest Rates and Bond Values

As reflected in Chart 1, the yield curve has steepened and then flattened this year. The 30-year Treasury yield peaked on June 12 and July 5 at 7.19 percent -- 124 basis points higher than at the beginning of 1996. It has since fallen to 6.40 percent.

CHART 1



To demonstrate the impact that interest rate fluctuations may have had on the market value of a bank's fixed income portfolio, Table 1 presents three types of fixed income securities common to a bank's portfolio: a Treasury bond, a FNMA mortgage pass-through, and a callable FNMA Agency bond. The value of each bond was computed on January 1, July 1, and November 25, 1996. Table 1 lists the percent change in the value of each bond between those dates.

Together the bonds lost 5.27 percent of their value through July 1, 1996, but they recovered 2.74 percent by November. Through the eleven months ending in November, the value of the three-bond portfolio was down 2.68 percent. On an aggregate basis, the Boston Region's banks fared slightly better. The value of securities holdings for all Call Report filers in the Region declined by only 0.91 percent for the nine months ending in September. Obviously each institution's investment portfolio performance will vary depending on the types of instruments held and the original acquisition price of each instrument.

The Boston Region's Bank Stock Performance

TABLE 1

EXAMPLE OF RECENT BOND PERFORMANCE

	US Treasury 30-Year Bond $100,000 Par 7.25% Coupon 7.75 yrs until maturity		FNMA Mortgage Pass-Through $100,000 Par 7.5% Coupon 7.59 yrs WAL		FNMA Callable Agency Bond $100,000 Par 7.55% Coupon 7.58 yrs until maturity		Total	
Date	Price	Change from Prior Period	Price	Change from Prior Period	Price	Change from Prior Period	Price	Change from Prior Period
11/25/96	$107,375	3.84%	$100,280	2.19%	$102,240	2.14%	$309,895	2.74%
7/1/96	$103,406	(7.08%)	$98,130	(3.90%)	$100,100	(4.68%)	$301,636	(5.27%)
1/1/96	$111,281		$102,110		$105,020		$318,411	

SOURCE: Bloomberg

PROTOTYPE

The stock market generally reacts unfavorably to rising interest rates, and reflecting this, the S&P 500 gained only slightly more than 3 percent through July (the latest peak in long-term rates). Since July the decline in rates has propelled the S&P 500 to new record levels, up 21 percent this year. The S&P Bank Index, however, has performed well for most of the year, despite the period of rising rates that occurred during the first two quarters of 1996.

The stellar performance of the money center banks this year -- with Citicorp and Chase Manhattan alone up over 60 percent on the year -- caused the S&P Bank Index to outperform indexes that track the performance of the Boston Region's banks. The Boston Regional Bank Index (BRBI), created by the Division of Insurance (DOI), consists of the Boston Region's ten members of the American Banker Bank Index, which includes the 225 largest publicly-traded banks or bank holding companies. *The BRBI, which is weighted by total market value of shares outstanding, has gained 32 percent on the year, with performance closely tracking the S&P Bank Index*. The BRBI shares its two largest institutions with the S&P Bank Index: Bank of Boston and Fleet Financial Group.

Do Yield Curve Spreads Provide a Peek at Future Bank Stock Performance?

A recent study by Merrill Lynch suggests that the slope of the short-end of the yield curve is a useful predictor of near-term bank stock performance relative to the broader market. For the period 1950 through 1995, the median performance of bank stocks in the study's universe outperformed the broader S&P 500 index 76 percent of the time in the twelve months following a widening of spreads between the 5-year and 3-month Treasuries. In contrast, the median underperformed the broader market 75 percent of the time in the twelve months following compression in the 5-year and 3-month spread. Chart 3 on the following page plots this concept through 1995.

The results of this study are intuitive. A steepening yield curve favors widening interest margins. The opposite is true as the yield curve flattens.

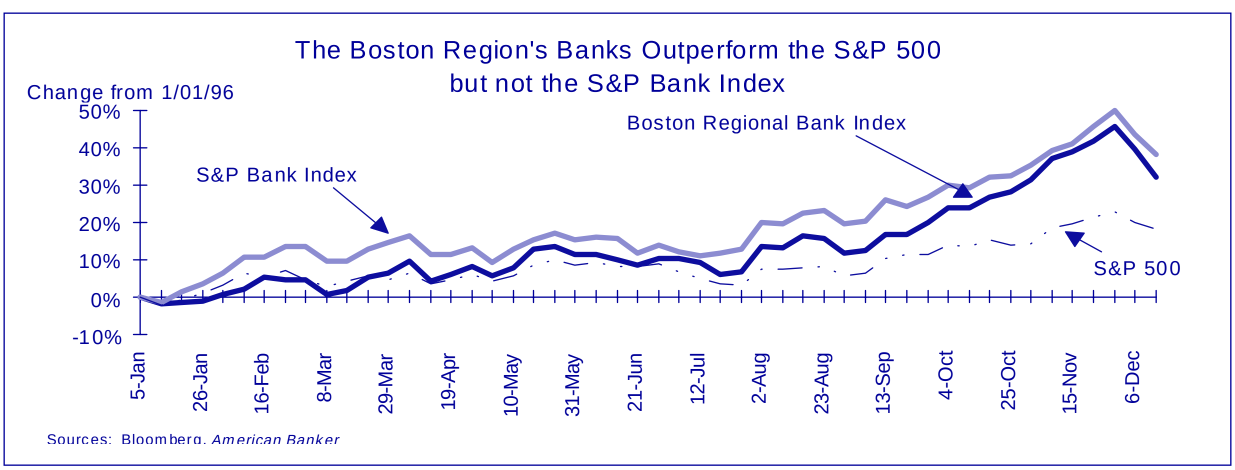
Did the change in the 5-year/3-month spread over the previous year portend the recent strength in bank stocks? Not in this case. For the twelve months ending October 1996, bank stock performance relative to the broader market was strong despite a decline of nearly 200 basis points in the 5-year/3-month spread during the preceding twelve months.

This recent departure from the historical pattern may have resulted from the market's recognition of widespread cost-cutting and "right-sizing" programs, as well as merger and acquisition activity. Also, bank stock performance has been buoyed by the use of excess funds to repurchase outstanding shares at many institutions, which drives earnings per share higher.

A New Product for Managing Exposures to Yield Curve Twists

Managing earnings exposures to changes in the yield

CHART 2



Prototype

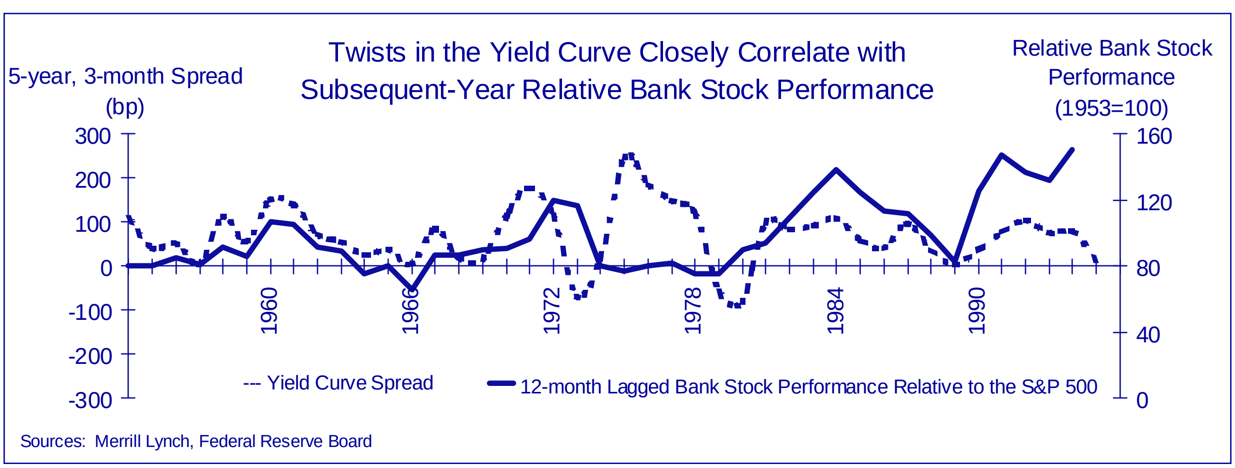
curve typically requires altering cash market positions, executing customized financial derivatives, or contracting multiple positions in exchange-traded derivatives instruments. *Recently, the Chicago Board of Trade (CBOT) introduced new products that may eventually simplify managing this risk -- Yield Curve Spread Futures and Futures Options (YCSF).*

YCSF contracts are structured so the payoff changes only in response to changes in spreads between points along the Treasury yield curve, rather than shifts in the overall level of interest rates. These instruments may provide advantages over hedges involving multiple positions in interest rate derivatives that attempt to isolate spreads along the yield curve. Ten futures contracts with spreads that cover the 2-, 3-, 5-, 10-, and 30-year maturity points were initially approved for trading. Options on these contracts also are traded.

In theory, YCSFs could be used to construct hedges for specific interest-sensitive securities, or more macro hedges based on an institution's overall balance sheet structure. Regardless of how they are used, a great degree of sophistication would likely be needed to construct meaningful hedges. Insured institutions that execute YCSF contracts should be cognizant of the fundamental risks identified in the FDIC's supervisory policy addressing financial derivatives.
Initial trading in the YCSFs has been thin and for some contracts non-existent. A CBOT representative indicated that position holders have been fairly diversified with most of the volume derived from speculators and traders for proprietary accounts.

Allen Puwalski, Banking Analyst
Steven E. Cunningham, Senior Financial Analyst

CHART 3



Regional Banking Conditions

- **Earnings, capital, and asset quality at the Region's banks reflect the overall health of the banking industry.**
- **After years of malaise, real-estate construction lending appears to be on the rise.**
- **A significant increase in noncore funding sources raises long-term liquidity concerns.**
- **Strong growth in, and competition for, consumer and commercial loans may be elevating risk levels.**
- **Smaller institutions have had only moderate success in expanding noninterest income sources.**

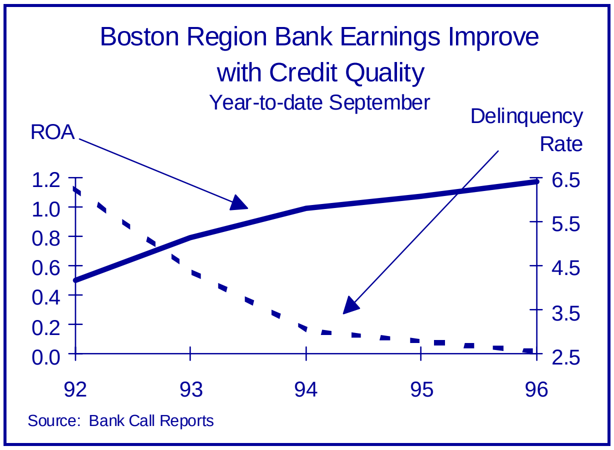
Overall Banking Conditions Strong

The ongoing economic recovery in New England continues to positively affect the health of insured banks and thrifts in the Boston Region. *By most measurements, particularly earnings, capital, and asset quality, the overall condition of the industry is as strong as it has been in at least ten years.* However, overall growth of the New England banking industry is slow as a result of slow growth in the Region's economy coupled with increasingly intense competition on both sides of the balance sheet.

As of September 30, 1996, 98 percent of all institutions in the Region were considered "well capitalized." Only one institution was categorized as "undercapitalized." The average Tier 1 capital ratio for the Region's banks was nearly 8 percent, with institutions over $1 billion approximating 7.25 percent and all other institutions over 9.5 percent.

While slow growth has positively affected capital levels, it also has made it increasingly difficult for stock-owned institutions to maintain returns-on-equity at levels demanded by the market. Thus, these institutions have been returning an increasingly larger portion of retained earnings to their shareholders in the form of dividends. For the nine months ended September 1996, the dividend payout rate for all stock-owned institutions in the Region was 77 percent, up from only 14 percent five years ago. The inability to generate growth through internal means also may have contributed to increased merger and acquisition activity, both regionally and nationally.

CHART 1



Asset Quality Steadily Improving

Asset quality indicators have shown steady improvement within the Region since 1992 (see Chart 1). These aggregate figures mask considerable variation by loan category, however.

Commercial real estate loans continue to have the highest delinquencies across the Region at 3.8 percent. Consumer loan delinquencies are approximately 3.5 percent. However, whereas the commercial real estate loan delinquency rate has fallen steadily, from nearly 10 percent in the beginning of 1993, consumer loan delinquencies appear to be on the rise. Net charge-offs on credit card loans also are beginning to rise but remain below the national average at approximately 3 percent. *Consumer loan underwriting practices, credit scoring systems, and collection activities should be closely monitored, although this segment of the portfolio does not appear to pose a significant risk to the Region at present* (see ***Consumers Declare Bankruptcy in Record Numbers).***

PROTOTYPE

Earnings Growth Continues

Earnings of insured institutions within the Region are steadily improving and are considered strong. Commercial banks had a return on assets (ROA) of 1.08 percent for the third quarter (1.30 percent if one ignores the impact of a one-time restructuring charge taken by a single large bank), while mutual savings banks earned 0.95 percent. Federally chartered thrifts earned only 0.26 percent as a result of the SAIF special assessment; without the special assessment, however, core earnings would have approximated 0.90 percent, in line with mutual savings banks and ahead of the 0.75 percent returns posted for comparable periods in each of the previous three years. Forty-seven of the 56 SAIF-insured institutions posted quarterly losses -- all but one of which directly resulted from the special assessment.

Year-to-date ROA for the Region was 1.17 percent (1.22 percent adjusted for the one-time charges just mentioned), continuing a positive trend in ROA that has been evident since 1992 (see Chart 1 on previous page). *The elimination of the deposit insurance assessment for most institutions added approximately five basis points to year-to-date ROA (ten basis points in the quarter).*

Like Connecticut's economy, its banks' earnings continue to lag the rest of New England as year-to-date returns approximate 1 percent. However, this return is a significant rebound from the 0.29 percent ROA posted in the same period in 1993 (see Table 1).

For the Region in the aggregate, net interest income to average assets continues to decline slightly, but this has been more than offset by improved noninterest income and lower overhead. *The larger banks are the major contributors to the improvement in noninterest income, with banks over $1 billion increasing this income source as a percentage of assets by 65 basis points in the past three years.* Banks under $1 billion have gained less than one third of this amount and have largely attained significant profitability improvement through reduced overhead and low provisions for loan losses. These sources cannot be relied upon for significant future earnings enhancement as they have already been managed down to very low levels.

Earnings pressures may increase for small institutions, particularly if low overhead and provision expenses cannot be maintained. Augmenting traditional lending and deposit taking businesses with more fee based activities may be an alternative strategy that will be pursued by some institutions. The pressure to pursue alternatives to traditional activities may become particularly acute if interest rates decline, since smaller institutions place a much greater reliance on nonmaturity deposits as a funding source. As demonstrated in Chart 2, rates paid on these deposits (cost of funds) have been held significantly below market rates (Fed funds). It will be difficult to maintain existing margins in a downward rate environment as these deposits, particularly NOW and savings accounts, have little room for further downward movement.

TABLE 1

CONNECTICUT BANKS, LIKE STATE'S ECONOMY, CONTINUE TO LAG REGION
(PERCENT EXCEPT # OF BANKS)

STATE	ROA Q3	ROA YTD	NPL /TL	PDL /TL	# OF BANKS
CT	0.96	1.04	2.04	3.62	89
MA	1.08	1.15	1.07	2.22	258
ME	1.29	1.26	1.31	2.66	48
NH	1.10	1.50	1.53	3.12	47
RI	1.11	1.42	0.90	1.83	14
VT	1.61	1.65	1.46	2.94	29
REGION	1.04	1.17	1.27	2.55	485

Ongoing Consolidation

As of September 30, 1996, there were 485 insured banks and thrifts in the Region, down from 549 (a 12 percent decline) at year-end 1993 (includes 6 failures). Continued consolidation of the industry is likely as larger banks seek to expand delivery points and leverage capital, and smaller banks combine to achieve economies of scale necessary to grow profitably and expand into new business lines.

Consumer & Commercial and Industrial Loan Growth Outpacing Real Estate Lending

Total assets of insured institutions in the Region have grown approximately 3.5 percent each year since 1993 and reached $311 billion as of September 30, 1996. The asset mix is essentially unchanged, with approximately 61 percent of total assets centered in loans. Within the loan portfolio, however, the mix has been shifting away from real estate loans into both commercial and consumer. New England institutions, at least until recently, have not expanded real estate loan portfolios despite evidence of improved markets and a significant tightening of vacancy rates.

There are signs that *banks are now beginning to look to real estate opportunities -- which may result in new construction activity within the Region.* Since year-end 1995, the only sector of the real estate portfolio that has had meaningful growth is construction loans, which are up 13 percent (up an annualized 17 percent for the most recent quarter). Loan commitments for both commercial and residential real estate loans also are on the rise. *To date, there is very little speculative building activity despite a fairly healthy absorption rate and diminishing supply;* however, it appears that the Region's institutions are gradually getting back to real estate lending.

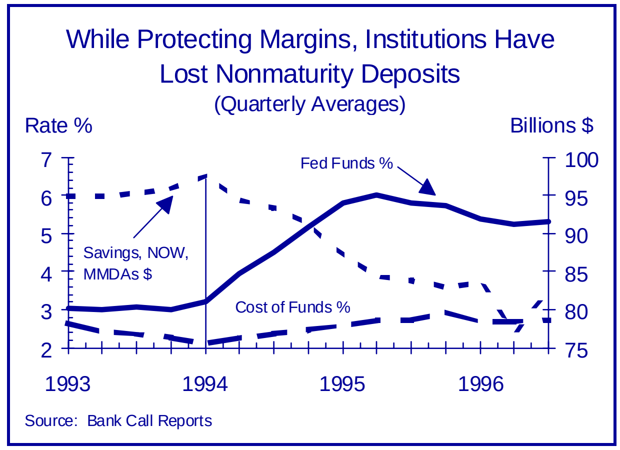
While real estate loans have actually declined 3 percent in aggregate in the past three years, other loan categories have grown by 38 percent, led by a 47 percent increase in consumer loans. Commercial loans are up 31 percent over this time frame, as banks have aggressively sought these credits to bolster net interest income. Commitments for these portfolios also are up significantly. There is evidence that competition is affecting pricing, particularly in the commercial sector, and concerns are raised as to whether underwriting standards are being loosened.

Recent surveys of OCC examiners indicate that the inherent credit risk in its larger institutions has increased, particularly in consumer and small business loans -- precisely where the growth has been in this Region. While recent FDIC examinations found that only 7 percent of supervised banks within the Region had greater than average risk in the loan portfolio, 25 percent cited above average *competitive pressure that was negatively affecting pricing relative to risk. This may also lead to compromised underwriting standards which will become more apparent if the economy weakens.*

Increased Reliance on Noncore Funding Noted

Despite the nominal growth that the Region has experienced, *banks have become increasingly reliant on noncore funding sources to support asset expansion.* Since the trough in interest rates that occurred in the fourth quarter of 1993, core deposits (nonmaturity deposits plus CDs under $100,000) have actually declined in the Region by $2 billion. The decline in interest bearing nonmaturity deposits (savings, NOWs, and MMDAs) is even more pronounced and results primarily from the industry's desire to hold down deposit costs in order to enhance margins. For bank Call Report filers (94 percent of the Region's assets), these deposits have declined $15 billion (15 percent) since December 1993 and now fund 28 percent of total assets, down from 36 percent in 1993. The decline in the nonmaturity deposits has been partially offset by retail certificates of deposit, but the major source of funds for growth has been in noncore deposits and borrowings. These sources have grown by $25 billion and now fund nearly 30 percent of the Region's assets, up from about 20 percent only three years ago. This trend is evident for institutions of all sizes and may adversely affect liquidity as well as reduce some institutions' ability to manage interest rate risk.

CHART 2



It is interesting to note that the $20 billion credit union industry in New England had deposit growth of $1.6 billion (10 percent) over the same time frame. Additionally, the Federal Reserve Board's Flow of Funds analysis indicates that household investment in money market mutual funds grew by 46 percent during this period. These growth patterns suggest that individuals continue to seek safe, interest bearing investments and have become increasingly willing to move funds outside the banking system to find acceptable returns.

Daniel Frye, Senior Regional Analyst